USAID/PADCO

Pension Reform Program in Ukraine

NOVEMBER 1999

PADCO / USAID

Tel.: (044) 463 7615, -16, -17

FAX: (044) 463 7614

e-mail:

rvaughan@padco.kiev.ua

LESSONS FOR UKRAINE:

THE FAILURE OF PENSION REFORM IN KAZAKHSTAN

PREPARED FOR THE MINISTRY OF LABOR AND SOCIAL POLICY OF UKRAINE AND THE PENSION FUND OF UKRAINE

SUMMARY: LESSONS FROM KAZAKHSTAN FOR UKRAINE

KAZAKHSTAN'S PENSION REFORM

On January 1, 1998, Kazakhstan introduced sweeping pension reforms that many people believe should serve as the model for Ukraine to follow today. The old solidarity system was replaced by a system in which employees were required to make contributions into individual pension accounts offered by private pension funds. The 25.5% payroll contribution was still imposed on employers, but 10 percent was diverted into the new individual accounts, and state budget revenues were used to supplement the remaining 15.5% of payroll contributions to pay remaining benefits under the old solidarity system. Newly created asset management companies decided where to invest the assets of these pension funds and the accumulated contributions and earnings were held by custodians on behalf of beneficiaries. The accumulated balances would be returned to these workers at retirement in the form of pension annuities. The old solidarity system was maintained to provide basic pension benefits, but would slowly shrink over time.

Kazakhstan hoped the new system would link pension benefits with past contributions directly, de-politicize the process of setting pension benefit levels, and bring the discipline and efficiency of private capital markets to the management of the pension system. In addition, the investments of the fund balances would provide Kazakhstan with long-term capital to support the nation's economic development. International donors strongly endorsed the plan and provided Kazakhstan with financial and technical assistance.

Kazakhstan in 1998 was in a better position than Ukraine is today to implement this type of reform (see table at the end of this summary): Kazakhstan's per capita income was nearly 50% higher than Ukraine's; its banking sector was more advanced; and its solidarity system imposed a much lighter burden on working people than does Ukraine's.

MISTAKES IN DESIGN AND IMPLEMENTATION OF REFORM

Today, however, the reforms are collapsing – with mounting government deficits, pension arrears lengthening, compliance in contribution payments falling, and widespread violations of prudent investing and laws intended to protect participants. Why?

Kazakhstan Tried to Pay for Pension Reform Through Borrowing.

- A mandatory accumulation system financed through state borrowing cannot meet the government's goals of providing better benefits at lower costs. The government failed to consider why it wanted the new system and how it would pay for it. The enormous additional costs of the accumulation system have vastly inflated state budget deficits in 1999 and these deficits will get worse over time.

Kazakhstan's Undeveloped Private Capital Markets and Financial Institutions Could Not Support the Rapid Development of the New System

- Asset managers cannot find enough safe and liquid securities to build a well-diversified portfolio with the mandatory contributions because Kazakhstan's capital markets are poorly developed, investments in foreign assets were prohibited, and the scheduled privatization program of large scale state enterprises was cancelled.
- The National Bank of Kazakhstan invested the assets of the State Accumulation Fund for the benefit of the government rather than for the benefit of fund participants.

The Attempt to Implement New Administrative Systems Too Quickly Led to Poor Design and Implementation Decisions

- Budget revenues have fallen as economic activity flees into the gray economy due to worsening administration of the old and new pension systems.
- The last minute creation of the State Accumulation Fund as one of the entities that could manage the funds of the new mandatory accumulation system changed the new pension system from one based on private asset management to one dominated by state asset management.
- Solidarity system compliance rates fell sharply the reporting and record keeping of the solidarity system were not personified, as well as the decision to change, during the pension reform process, the agency responsible for collecting solidarity system contributions.
- Inadequate time was spent building the administrative systems to support the reformed pension system, resulting in issuing many erroneous individual identification numbers, inability to track individual account balances, and misallocation of contributions between the solidarity and accumulation systems.
- Failure to enforce the pension reform law resulted in violation of the anti-affiliation rules between custodians and asset managers or pension funds and of participant's rights to freely transfer money among pension funds.

HOW UKRAINE CAN AVOID REPEATING KAZAKHSTAN'S MISTAKES

There are five rules Ukraine should follow in implementing its own pension reform program that can avoid the mistakes of Kazakhstan.

Rule 1: Finance Pension Reform From State Budget Surpluses Not From Borrowing. Make accurate financial projections, identify sources for financing, and don't go deeply into debt.

Rule 2: First, Fix the Financial Problems of the Solidarity System. The best way for Ukraine to pay for pension reform is from surpluses generated by a reformed solidarity system. These reforms must include raising the retirement age, eliminating many privileges, and improving overall administrative efficiency. Ukraine does not have large oil and gas reserves nor will it receive large financial bonuses from large-scale privatization. Instead, it should make these improvements in its solidarity system during the relatively favorable demographic conditions and "pre-fund" future pension reforms from the savings.

Rule 3: Make a Mandatory Accumulation System One of Three Pillars of the New Ukrainian Pension System. Only introduce a mandatory accumulation system when there are many suitable investments -- domestically and internationally, when the necessary accounting and regulatory reforms have been made (and tested), and when the other preconditions have been met.

Rule 4: Phase In New Pension and Administrative Systems. Sudden changes in the administration of pensions and capital market regulations are not easy. They should be designed carefully, tested thoroughly, and monitored scrupulously.

Rule 5: Always Remember, Pension Funds Must be Managed for the Primary Benefit of Participants. Pension funds should never be viewed as a cheap way for the government to borrow or as a cheap source of investment capital to spur economic development.

COMPARING KAZAKH AND UKRAINIAN SOCIAL AND ECONOMIC CONDITIONS[1]

POPULATION	KAZAKHSTAN	UKRAINE
Total population: 1997	16 million	50 million
Population density (persons per km²): 1997	6	89
Percent urban: 1997	60.4%	71.1%
Percent population over 65 years old: 1997	7.0%	14.0%
Dependency ratio (workforce as percent of children and pensioners):	56.3%	49.9%
Annual population growth rate: 1975-97	0.7%	0.2%
Projected annual population growth: 1997 – 2015	0.2%	-0.4%
Fertility rate (children per woman)	2.3	1.4
Life expectancy at birth	67.6	68.8

ECONOMY (1997)	KAZAKHSTAN	UKRAINE
GNP ($US)	21.3 billion	52.6 billion
GNP per capita ($US)	1,350	1,040
Real GDP per capita ($US purchasing power parity)[2]	3,290	2,170
Labor force (millions)[3]	8	25
Percent employed in manufacturing	27%	40%
Percent employed in services	61%	48%
Percent employed in agriculture	12%	12%
Unemployment Rate	4.1%	2.1%

PENSION SYSTEM)	KAZAKHSTAN	UKRAINE
Number of pensioners (000)	2,037[4]	14,100
Pensioners as percent of population	13%	28%
Total pension system expenditures as percent of GDP	?	?
Payroll contribution rate to support solidarity system	15.5%	34%
Average pension benefit per pensioner	XX	XX

[1] Sources: Unless otherwise indicated, data are from the United Nations, *Human Development Report 1999*, published by the Oxford University Press, 1999.
[2] From The World Bank, *World Development Report 1998-99*, Washington DC, 1999
[3] Ibid
[4] Agency for Statistics of the Republic of Kazakhstan

TABLE OF CONTENTS

1. INTRODUCTION

In 1997, the Parliament of Kazakhstan passed a sweeping pension reform program. The old state solidarity system was to be replaced by a new system based on mandatory contributions into individual accounts.[5] The new system was introduced nationwide on January 1, 1998 – barely six months after the law was passed. In many ways, Kazakhstan was in a better position to implement this type of reform than Ukraine is in today. Kazakhstan's per capita income was nearly 50% higher than Ukraine's; its banking sector was more advanced; its budget system was in better balance; its solidarity system imposed a much lighter burden on working people than does Ukraine's. On top of these advantages, the design and the development of the new program was supported by several international donors. The World Bank promised a credit of $300 million and the Asian Development Bank a credit of $100 million to help pay off pension arrears and to finance the transition. The United States Agency for International Development committed to provide up to five years of technical assistance during the transition.

Today, however, less than two years after this optimistic beginning, Kazakhstan's reformed pension system is in ruins.[6] The State budget deficit has ballooned out of control. In October 1999, President Nazerbaev appointed a new Prime Minister and replaced most government officials closely associated with the pension reform.

Why did Kazakhstan's program for pension reform fail less than two years from the date it began? This paper analyzes four types of causes – failures in the underlying concept of the purposes of reform, failures because of poor fiscal projections of the costs of reform, failures because of Kazakhstan's incipient private capital markets were unable to support the sudden infusion of funds, and failures because of the poor design and implementation of the reform program. The conclusion is that Ukraine would be even more vulnerable to the same problems that have beset Kazakhstan if Ukraine were to attempt the same course of action. Yet Kazakhstan's model has been recommended to Ukraine by several international advisors as the course of action Ukraine should follow.

This advice is wrong. Kazakhstan basic lesson for Ukraine is that a mandatory accumulation cannot and should not be rushed into implementation until the basic building blocks are in place. The building blocks for a mandatory accumulation system include a sound private capital market, a reliable regulatory structure, and a fiscal surplus to pay for the transition. Even when Ukraine enjoys the benefits of all these "preconditions", it should phase in a mandatory accumulation system slowly, and use it as only one of the three pillars of its pension system – not as a complete replacement for the solidarity system.

This report describes Kazakhstan's pension reform program and examines why it has encountered such severe problems. The motivation is to extract the lessons from this experience so that policymakers in Ukraine can avoid repeating the mistakes. Section 2 of this report describes the basic elements of Kazakhstan's new pension system in detail. Section 3 analyzes the reasons for the failure of reform. The final section describes how the lessons from Kazakhstan can be applied to the design and implementation of pension reform in Ukraine.

[5] The new pension system was defined in Decree of the Republic of Kazakhstan # 819, "On Adoption of the Concept Paper of pension System Reform," issued on May 12, 1997.
[6] In May 1998, PADCO issued a report entitled, "Lessons for Ukraine, Problems with the Kazakh Non-State Pension System". Unfortunately, many of the problems outlined in that report have not yet been addressed. In addition, other problems have emerged, making the overall system worse.

2. KAZAKHSTAN'S PROGRAM TO REFORM ITS PENSION SYSTEM

On January 1, 1998, Kazakhstan introduced a sweeping and sudden reform to its pension system.[7] "The system of pension provision existing in Kazakhstan based on the principle of solidarity of generations has exhausted its possibilities," the new enabling law stated. "The financial crisis of pension fund requires radical changes and immediate pension reform."

The payroll contribution rate of 25.5% that had supported the solidarity system was maintained temporarily – but it was split in two. 15.5% went to the old solidarity system to pay for the benefits still owed under that system, but 10% was diverted into new pension funds were the contributions were invested and maintained on behalf of the individual worker. Workers retiring within the next few years would continue to receive their solidarity pension benefits, but, increasingly, most pension benefits would be paid from the accumulated balances in the individual pension accounts.

2.1 WHY KAZAKHSTAN ADOPTED THE MANDATORY ACCUMULATION SYSTEM AS THE BASIS FOR PENSION REFORM

Prior to reform, the Kazakh pension system was similar to Ukraine's system today. It suffered from many of the same problems. The State Pension Fund had significant arrears. Too many enterprises were avoiding paying existing in the gray economy, others were insolvent and unable to pay, and others were failing to report the full income of their employees in order to avoid the 25.5% payroll tax. The number of retirees was high because pension ages for men and women were low and many pensioners were receiving privileged pensions.[8]

The Government of Kazakhstan correctly realized that its solidarity system as then structured and administered was no longer financially viable – especially in the face of the aging of their population caused by declining fertility rates and greater life expectancy.[9] Major investments in computerization were needed to personify reporting and record keeping – a necessary step to increase compliance and to eliminate waste and fraud in the calculation of pensions. The government chose not to try to fix its existing system. Instead, after reviewing a wide range of alternatives, it chose a model based on mandatory accumulations into individual savings accounts as the way to replace the existing solidarity system.[10] The concept paper listed several reasons for this decision:

- The new accumulation system would link benefits directly to contributions– if workers or employers didn't contribute, then less money would be accumulated in workers' accounts, and retirement benefits would be smaller. The solidarity system offered most retirees the same pension benefits regardless of how long they had worked and how high their wages had been.
- Pension contribution rates should be reduced quickly to improve compliance rates and make businesses more competitive. The 25.5% contribution rate supporting the solidarity system was "a burden on the economy." Although state budget deficits would increase temporarily by cutting contributions to the solidarity system, deficits could be financed through government borrowing and with

[7] Decree of the Republic of Kazakhstan # 819, "On Adoption of the Concept Paper of pension System Reform," issued on May 12, 1997.
[8] Ukraine's situation is somewhat worse than Kazakhstan's because Ukraine has a much higher ratio of pensioners to workers (three pensioners for every five workers) than does Kazakhstan (only 1.25 pensioners for every five workers).
[9] The rate of live births in Kazakhstan had fallen from 2.9 per woman in 1980 to 2.1 children in 1990 (World Bank, *World Development Report 1998-99*, Washington DC, 1999, p. 202)
[10] Decree of the Republic of Kazakhstan # 819.

the proceeds from privatizing state enterprises, and, in the long run, through greater economic growth and revenues from the expanding oil sector.

- The new system would give individuals control over how their pension savings were invested and therefore encourage people to assume greater personal responsibility for their own economic well-being.
- The forced savings generated by the mandatory accumulation system would generate long-term capital to finance the country's economic growth.[11]

These perceptions of the advantages of a mandatory accumulation system over the more traditional solidarity systems are shared by many nations. They are defensible, logical reasons for initiating pension reform. But the beneficial outcomes that many supporters of pension reform anticipated have not yet been achieved. Today, it is doubtful that Kazakhstan will achieve any of these goals without substantial redesign of its pension reform program.

2.2 THE OVERALL STRUCTURE OF KAZAKHSTAN'S NEW PENSION SYSTEM

For workers just entering the workforce, the new mandatory accumulation system is intended to provide their full pension benefit at retirement. For current pensioners, all benefits will be continue to paid from the old solidarity system. Everyone who was working when the system was reformed will get benefits from both systems when they retire. The service credits accumulated under the old solidarity system will be "frozen" at today's levels. Future pay increases will, however, be taken into account when calculating solidarity system benefits.

This new accumulation system functions much like a bank account:[12]

- All workers are required to contribute at least 10% of their income into a pension fund of their choosing – either a private pension fund or the fund administered by the government. Workers may also make additional, voluntary contributions if they wish. Contributions are withheld from workers' pay by the employer, sent to the State benefits Payment Center, and then remitted to the custodian bank of the pension fund selected by the workers. Prior to April 1999, contributions were paid by employers on behalf of employees based on gross payrolls. Since then, the accumulation system contributions are deducted from employee wages.
- Pension funds are required to use separate and independent asset management companies to invest the workers' contributions. The State Accumulation Fund uses the National Bank of Kazakhstan as its asset manager.
- Investment income is regularly allocated to individuals' accounts held in custodian banks.
- At retirement, the balance in the account is paid out to the individual in the form of a lifetime annuity – calculated as the income that will use up the principle and accumulated interest of the savings account during the expected lifetime of the retiree.

To implement this new pension system, three new types of organizations were created by new laws:

- Pension funds;
- Asset management companies; and
- Custodians.

[11] Decree of the Republic of Kazakhstan # 819.
[12] Decree of the Republic of Kazakhstan # 819.

Asset management companies and custodians are required to be separate and independent from the other and was given different responsibilities within the new system.

2.2.1 Pension Funds

The entities with ultimate fiduciary responsibility under the Kazakh private pension system are the newly created private pension funds. Pension Funds receive all commissions (fees) and are responsible for performing, directly or indirectly, all required activities. By law, pension funds must hire independent, (or "outside") asset management companies, and independent, (or "outside") bank custodians. Although not specifically required, it was anticipated that pension funds will be directly responsible for sales and advertising and for individual record keeping. Fees that may be earned by pension funds are capped at 1% of contributions and 10% of investment income. All fees are retained by the pension funds (and are not credited to the individual accounts) and are used by the fund to pay the fees of the asset management companies and the custodians to cover their own operating expenses and to earn a profit.

There are three different types of pension funds: 1) the State Accumulation Fund; 2) corporate funds; and 3) open funds. Each has its own characteristics.

- <u>State Accumulation Fund (SAF)</u>: This is a state managed and owned "private" pension fund. The SAF is the default fund under the pension law. If employees do not choose any fund, their contributions are automatically deposited into the SAF. The asset manager for the SAF is the National Bank of Kazakhstan (which has chosen to invest virtually all SAF assets in government securities at interest rates set by the Ministry of Finance and the National Bank of Kazakhstan). The SBPC provides all recordkeeping and other administrative services to the SAF.
- <u>Corporate Pension Funds</u>: Employers, or groups of employers, can create private pension funds. Only employees of the corporations creating these funds may participate in them. However, employees are not <u>required</u> to participate in their employer's fund. They are free to select any fund, in theory. If employees leave their employers, then their account balances must be moved to whatever fund they nominate in their new jobs.
- <u>Open Funds</u>: Open funds are required to accept contributions from any worker in the country who selects their fund. Unlike corporate funds, they are not permitted to restrict membership.

2.2.2 Asset management companies

All pension funds – with the exception of the SAF -- are <u>required</u> to hire "outside" asset management companies, responsible for selecting the investments for worker's contributions and for reporting on the valuation of the assets to the pension fund. The asset management company – like the pension fund – is a for-profit, closed-end, joint stock company. Under Kazakh Law, the same groups of individuals or corporations are permitted to be founders of both an asset management company and open pension funds. This is not typically allowed in the West.

Investments must be made in accordance with guidelines, or "prudential norms", published by the National Securities Commission (NSC). These guidelines set minimum and/or maximum percentages of funds that can be invested in various classes of asset. For corporate and open funds, the guidelines are as follows:

- <u>State securities</u>: Minimum of 25% of a fund's assets must be invested in short-term government securities (one year or less), and a minimum of 25% must be invested in long-term government securities (over one year). This is the only category of investments with a minimum percentage.
- <u>Bank deposits</u>: Investments cannot exceed 40% of assets.

- Securities of international organizations: Up to 10% of a fund's total assets may be invested in the bonds of organizations like the World Bank or Asian Development Bank
- Kazakh "A" listed corporate equities:[13] Up to 20% of assets may be invested in the stocks of companies that are "A" listed on the Kazakh stock exchange. Today, because of the cancellation of Kazakhstan's privatization program, there is only one A listed stock.[14]
- Kazakh "A" listed corporate bonds: Up to 10% of assets may be invested in the bonds of companies that are "A" listed on the Kazakh stock exchange. At this time, there are no A listed corporate bonds traded in Kazakhstan.

For the SAF, the investment restrictions differ slightly. Investments in corporate bonds and equities are not permitted. Also, the SAF can only invest in certificates of deposit from state banks, not in direct bank deposits. There are only two Kazakh State Banks issuing certificates of deposit at this time. Kazakhstan's investment normatives allow a concentration of investments in state securities and in bank accounts that would not be permitted in the West. Table 1, below, shows how asset management of pension funds is regulated in a selection of western nations.

Table 1. Features of Funded Pension Programs in Selected Countries

Characteristics	United Kingdom	United States	Germany	Japan	Canada	Netherlands
Nature of Benefits	Largely defined benefits based on final salary	Most are defined benefits but many defined contribution plans available	Largely flat rate benefits with benefits based on years of service	Largely defined benefit based on years of work and salary. Often taken as lump sum.	Largely defined benefit based on final salary or flat rate	Almost all defined benefits based on final salary
Tax Treatment of Contributions and Benefits	Contributions and asset returns tax free; Benefits taxed (except lump sum)	Contributions and asset returns tax free; Benefits taxed	Employers contributions taxed as wages; employees contributions and asset returns tax free; Benefits taxed at low rate	Contributions tax free; Tax on asset returns. Benefits taxed except lump sum.	Contributions and asset income tax free. Benefits taxed.	Contributions and asset income tax free. Benefits taxed
Regulation of portfolios	Prudent man rule 5% self investment limit; concentration limit	Prudent man rule 10% limit on self investment for defined benefit plans	Guidelines: Maximum of 20% in equity; 5% property; 4% foreign; 10% self investment	Guidelines: Maximum of 30% in equity; 20% property; 30% foreign; 10% one company. Minimum 50% bonds	Prudent man rule; Tax on foreign assets over 10%; 7% limit on real estate	Prudent man rule; Maximum of 5% self investment

Source: E. P. Davis, *The Structure, Regulation, and Performance of Pension Funds in Nine Industrial Countries*, The World Bank, Policy Research Working Paper 1229, 1994.

2.2.3 Custodians

Pension funds are required to hire custodian banks, responsible for holding safely the assets that are accumulated from employee contributions and investment income earned on those contributions. All contributions are transmitted to bank custodians via the State Benefit Payment Center (SBPC). Neither cash nor

[13] The letter "A" refers to an evaluation of the financial strength of the issuer of the security. These evaluations are performed by private rating agencies that operate internationally.
[14] See, for example, the listing in XXXX, the daily newspaper issued in Almaty, on November 16, 1999.

assets (bond certificates, equity certificates, or access to bank deposits) are ever physically held by the pension fund or the asset management company. The primary responsibilities of the custodian bank are to:

- Hold custody of all contributors' assets. Note that many assets acquired by pension fund beneficiaries – such as state securities, stock certificates, etc. -- are jointly held on behalf of beneficiaries because they are too large to be apportioned to any single participant
- Collect contributions made by workers to the pension fund for which the bank is the custodian
- Physically execute purchases or sales (trades) of assets as directed by the asset management company
- Refuse to execute any trades that would violate the prudential norms for investments, and report the request for such trades to the appropriate authorities
- Pay benefits to beneficiaries as directed by the pension fund.

Custodians are subject to the same stringent minimum capital requirements that apply to commercial banks. The custodian must not be affiliated with the pension fund or the asset management company in any way. It must be completely independent. This regulation is intended to ensure the custodian's role as protector of the rights and interests of contributors does not conflict with its business relationships with the pension fund or asset manager. In a country with very few successful banks and few people experienced in managing assets, this regulation has proved difficult to enforce in practice. Ukraine would experience a similar shortage of skilled and experienced finance experts – especially while there are laws that limit the involvement of foreign financial companies from exercising a controlling interest in local financial companies.

Unfortunately, however, local Kazakh banks have no experience, expertise or understanding of the custodial function. No comparable functions exists in Kazakhstan, and the concept of holding money in trust for another, and managing that money in a prudent fashion for the exclusive benefit of the beneficiaries is unknown. No provisions for creating and training the staff of banks in this new function were included either in the GOK's plan for the implementation of reform nor in the technical assistance programs provided by international donors. Their activities, therefore, should be closely monitored to avoid errors and fraud. Ukraine will face the same problems when it creates private pension funds.

2.3 REGULATION OF THE MANDATORY ACCUMULATION PENSION SYSTEM

Responsibility for regulating the mandatory and voluntary accumulation system is not given to any single agency. It is divided among five entities. While there is nothing wrong in principle with dividing regulatory responsibility among different agencies, it nevertheless creates problems of coordination especially when the new system is created almost overnight – giving the regulatory agencies little time to develop their own procedures – let alone develop effective systems for sharing information and coordinating regulatory procedures. The five agencies are:

- The National Pension Agency (NPA)
- The National Securities Commission (NSC)
- The National Bank of Kazakhstan (NBK)
- The State Benefit Payment Center (SBPC)
- The State Tax Administration (STA)

National Pension Agency: The NPA is a government agency and is part of the Ministry of Labor and Social Protection (MLSP). It is responsible for licensing and regulating private pension funds.

National Securities Commission: The NSC is responsible for licensing and regulating asset management companies. It is also responsible for setting and enforcing all prudential norms relating to investments and for developing rules for asset valuation.

National Bank/NSC: The National Bank and NSC have joint jurisdiction over the activities of banks as providers of custodial services to pension funds.

State Benefit Payment Center: The State Benefit Payment Center was created under the Ministry of Labor and Social Protection. It replaced the State Pension Fund, which was eliminated as part of pension reform. The primary functions of the SBPC are to:

- Issue Social Individual Codes (SICs) to all retirees and workers. These are unique individual identification numbers – corresponding in use to Ukraine's Taxpayer Identification Numbers. The GOK decided to issue new, unique, individual identification numbers for the pension system. Workers and retirees were to apply and receive these codes first. Eventually, everyone in the population was to receive a code.
- Transmit accumulation system contributions to the custodian for the pension fund selected by each individual.
- Keep personified records for all contributions to the accumulation system. The government chose not to personify the solidarity system, since it is being phased out over time and benefits were frozen on January 1, 1998.
- Provide marketing and individual record keeping services to the State Accumulation Fund.

State Tax Administration: The State Tax Administration is now responsible for collecting contributions to the old solidarity system contribution. The reform program originally envisaged that the SBPC would collect these revenues. Under the old system, the State Pension Fund of Kazakhstan (not to be confused with the State Accumulation Fund) was responsible for collecting these contributions.

2.4 Administration of the New Pension System

Administrative responsibility is divided up among hree different organizations:

- SBPC. The SBPC is the key coordinating administrative agency. It is responsible for receiving contributions to the accumulation system (but not those to the solidarity system), maintaining personified records of these contributions, transferring contributions to the custodian banks, and submitting up-to-date records of accounts to the SAF.
- Employers. Employers are responsible for creating corporate pension funds, for deducting the mandatory contributions from wages, for transmitting these contributions to the State Tax Administration, and for reporting these activities to the relevant regulatory agencies.
- Pension funds, asset management companies, and custodians. Private pension funds are responsible for maintaining records of individual account balances and transmitting statements to participants.

2.4.1 Contributions and personification

Prior to reform, the State Pension Fund of Kazakhstan collected all pension contributions to the solidarity system (as does the Pension Fund of Ukraine today). The contribution rate was 25.5% of the wage fund and was paid entirely by employers. Under the new system, contributions to the solidarity system are paid directly to the State Tax Administration. Contributions from employees to the new mandatory accumulation system are withheld from employees' pay and paid to the SBPC. The transfer of contributions must be accompanied by personified reports.

Once the payments arrive at the SBPC, the Center should perform three functions:

- Use the personified report to update personified records of contributions made to the accumulation system on behalf of each participant.
- Audit the data received for reasonableness and accuracy and check it against records from prior months, and, in theory, reconcile data with contributions made by the employer to the solidarity system (information that the STA should provide to the SBPC). Reconciliation with the solidarity system was easier in 1998 when the SBPC was responsible for collecting contributions to both systems. It is much more difficult now.
- The Center determines how much money should be paid into the individual accounts held by the custodian for each pension fund. It uses data submitted through the personified reports for all workers in the country, rearranges it by pension fund selected, and transmits the money and the personified records to each custodian. This is supposed to be done in 24 hours but typically takes between three and five days

2.4.2 Individual record keeping

Maintaining records of the accumulated account balances of individuals involves:

- Tracking transfers between funds (participants are free to move their accumulated savings among different pension funds)
- Calculating the total amount of investment income earned by each pension fund
- Allocating investment income to each individual participating in that fund
- Calculating and deducting legitimate fees and charges against the contributions made to and the gross income earned by each pension fund and pro-rating these expenses among all individual accounts
- Balancing and reconciling individual accounts to the total assets of each pension fund.
- Issuing statements for individuals.

2.5 HOW MONEY FLOWS IN THE REFORMED KAZAKH SYSTEM

All workers in all industries must participate in the mandatory accumulation system. Employees are required to contribute 10% of their pay to one licensed fund of their choosing. If employees do not chose a fund, they are automatically enrolled in the State Accumulation Fund. Twice a year, employees may transfer accumulated contributions (plus accrued earnings) from one pension fund to another, but are then obligated to pay future contributions into the new fund. Either employers (on behalf of employees) or the employees themselves may voluntarily contribute additional funds to their pension funds. Mandatory contributions are tax deferred – income taxes are paid only on income received from the pension fund after the participant has retired. This is typical for such systems – see Table 1, above. Taxes are also deferred on a certain level of voluntary contributions.

The contributions made into pension funds are invested. The fund must maintain records of the earnings accumulated by each individual account. The pension fund must allocate the investment income to each participant's account on a monthly basis, and provide employees with statements of their account balances at least once per year. The employee may request more frequent information.

At retirement, employees will receive the funds accumulated in their personal accounts. Retirement age under the mandatory system is generally the same as the retirement age under the solidarity system. As of July

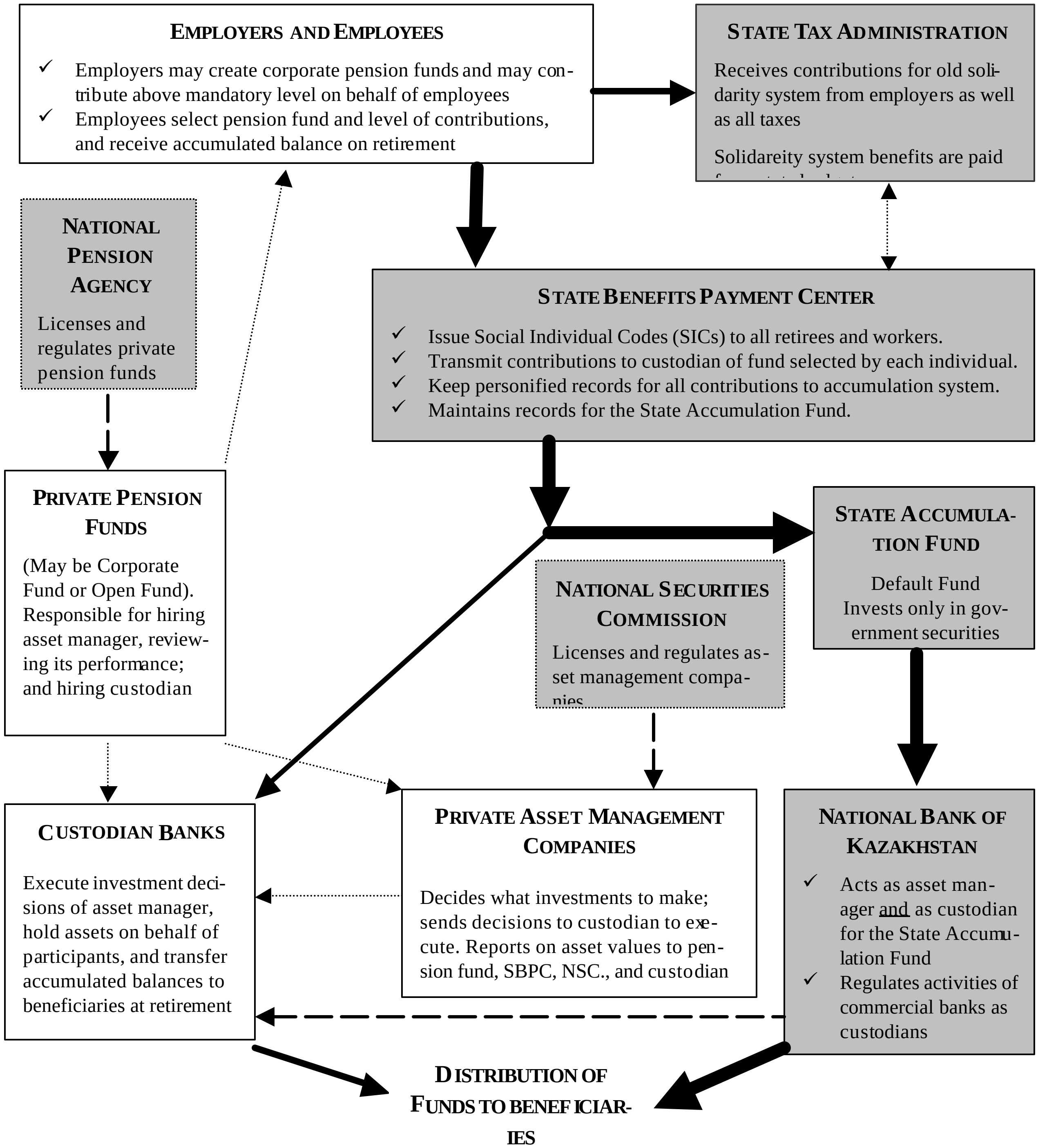
1, 1999, the retirement age was 62 for men and 57 for women. This is to increase by 6 months each July 1 until it has reached 63 for men and 58 for women.

Until December 31, 2000, benefits from the mandatory accumulation pension system will be paid as lump sums, since account balances will be small. Thereafter, benefits will be distributed as regular payments over time – called annuities. The mechanism for converting the lump-sum into regular payments has not yet been worked out, but it is hoped there will be a functioning life insurance industry by then, and workers will be required to buy an annuity from an insurance company of their choosing with their distributed benefits. This means the pension fund will give the worker's accumulated contributions to an insurance company, and the insurance company will then make periodic payments to retirees for as long as they live.

There is also a minimum pension guarantee provision in the new law. Anyone who participates in the new system at least three months out of every four months between 1 January 1998 and retirement age will be covered by the guarantee. Basically the government promises that the sum of the benefit from the old solidarity system and the new accumulation system combined will not be less than the poverty level. The minimum pension guarantee is a contingent liability of the State Budget. It is not funded, nor are any reserves held to pay for this liability.

The overall operation of the new system is shown schematically in Figure 1. Solid arrows connecting the boxes show financial flows, dotted arrows show information flows and dashed arrows show regulatory oversight. Shaded boxes show government institutions and clear boxes show private institutions.

FIGURE 1: KAZAKHSTAN'S NEW MANDATORY ACCUMULATION PENSION SYSTEM



KEY

Solid arrows show financial flows; dotted arrows show information flows; dashed arrows show regulatory oversight. Shaded boxes show state institutions; clear boxes show private institutions.

3. WHY PENSION REFORM IN KAZAKHSTAN FAILED

This section explains in greater detail why the Kazakh pension reform program has so far failed to achieve its goals. The section distinguishes four types of reasons:

- Failure in Conceptual Design
- Failures Because of Poor Interpretation of Fiscal Analysis
- Failures Caused By Kazakhstan's Undeveloped Capital Markets
- Failures Because of Poor Decisions During Design and Implementation

3.1 FAILURE IN CONCEPTUAL DESIGN

One of the most disturbing aspects of the Kazakh pension reform is that neither the GOK nor its international advisors ever clarified the conceptual framework for analyzing pension reform. The GOK was convinced that the solidarity system was broken beyond repair and wanted to replace it with something better. An accumulation system modeled on that introduced in Chile in 1981 seemed like the best alternative. But it never sorted out the relative roles for the public and private sector in the new accumulation system. Much of the benefits of the Chilean model that the GOK had selected must come from the wiser and more productive investments made on behalf of participants by private financial firms compared with the lower rates of return earned on government investments. But Kazakhstan lacked almost all the conditions for privatizing pension investments – most obviously, it lacked private financial markets, safe domestic investments, and a regulatory structure to ensure that private firms behaved competitively and in the interests of participants. Thus, the GOK was forced to view the mandatory accumulation system as an integral part of the government's social protection system. Since it sees the system this way, it subjects it to strict State control. This has prevented it from operating properly within a multi-pillar pension system.

When policymakers consider creating a mandatory accumulation system to supplement or replace an existing "pay-as-you-go" (or solidarity) system, they usually consider four arguments for this action – none of which, alone, is sufficient conditions for creating such a system:

1. To "smooth out" over time fluctuations in contribution rates and benefits that demographic changes in the ratio of contributors to pensioners would cause in a pay-as-you-go system. This is an argument for pre-funding rather than for creating an accumulation system
2. To privatize pension administration and/or asset management and to give to private companies some or all of the responsibility for the collection of pension revenues, the investing of reserves, or the distribution of pension benefits on the grounds that private enterprise can perform these functions more efficiently than can government agencies. But privatization does not necessarily imply a system that is either mandatory or that requires full accumulation
3. To force people to set aside money during their working lives so that they will not become dependent on government welfare benefits during their old age. This justifies a mandatory system, but not necessarily a fully-funded system
4. To reduce the extent to which short-run political considerations – the desire to increase pension benefits today – may create long-term financing problems. This justifies linking benefits to accumulated contributions – but not necessarily for complete funding of the system.

These reasons are examined in turn in the following subsections:

3.1.1 To Smooth Out Over Time Sudden Fluctuations in Contribution Rates or in Benefit Levels

A mandatory accumulation system can help solve long-term demographic problems experienced by pay-as-you-go systems. In many countries, and Kazakhstan and Ukraine are good examples, the ratio of pensioners to workers (what is called "the system dependency ratio") will increase over time. The percent of Kazakhstan's population over the age of 65 is forecast to increase from 7.0% in 1997 to 8.4% in 2015 and to continue growing at an accelerated pace after that date.[15] The fertility rate – the number of children born to each woman between the age of 15 and 40 – is declining. It was 2.9 in 1980, has fallen to 2.1 today, and is projected to continue falling.

One solution to this dilemma is to "pre-fund" a part of future benefits payments by collecting more money today than is needed to pay today's pensioners and to use this accumulated reserve (or the income it generates through investments) to pay benefits in the future when the dependency ratio rises.

Without pre-funding, the alternative is either to reduce benefits to pensioners or to raise the contribution rates from workers. Neither Kazakhstan nor Ukraine considers themselves in a position to follow either alternative without serious repercussions – either from pensioners or from employers. The success of pre-funding depends on investing the pre-funded reserves efficiently and ensuring that the funds are properly protected from raids either by the government or the Parliament. Both typically view any funds set aside for the future as an attractive resource to be distributed to voters today. As more and more benefits can be paid from the income from the accumulated reserves, benefit payments financed from the solidarity system could be reduced, so the required amount of pre-funding declines – thereby offsetting partially or wholly the problems of the mounting dependency ratio.

If "pre-funding" is the reason for creating an accumulation system, more money must be contributed to the pension system today – from public and private sources – than is needed to pay today's pension benefits. But where do these contributions come from? In countries where payroll contribution rates are already very high (and Ukraine's contribution rate, at 34%, is considerably higher than Kazakhstan's at 25.5%), raising the rate is not a viable solution. Neither can the government make payments into the "pre-funding program" from general revenues if it is already suffering from a high budget deficit. Kazakhstan and Ukraine both suffer from high state budget deficits. The third alternative is to borrow. But if the government borrows to make the additional contributions today, no pre-funding has really occurred. This is clear when one views the problems of the government in the future. The government borrows today by issuing securities and invests the money in the pre-funding program, it will face two groups of people wanting the money that has been accumulated: the people who loaned the government the money will want to be repaid and pensioners will want to receive their pension benefits from the new accumulation system. The government will either have to say no to the pensioners and pay them from the solidarity system, or it will have to borrow even more money to repay the original bondholders.

There are two reasonable sources for a rational "pre-funding" program:

1) Restructuring the solidarity system to increase compliance rate among contributors, raise the efficiency of system administration, eliminate fraud in benefit calculations, raise retirement ages, and eliminate expensive privileges; or

2) Divert into the "pre-funding" program any "one-time" fiscal gains from programs such as the privatization of state assets, natural resource severance taxes, or some other temporary source of increased general revenues to the state budget.

---

[15] See United Nations, *The Human Development Report 1999*, New York, Oxford University Press, 1999, Table 16. The comparable data for Ukraine are 14.0% in 1997 and 16.2% in 2015.

Kazakhstan rejected the task of overhauling the state solidarity system as a way to earn a surplus to pay for pre-funding. It did, however, plan to use the second method for a portion of the pre-funding. Pre-funding future pension obligations would be supported, the GOK hoped, through the proceeds from privatizing large state enterprises and from the anticipated oil boom that followed from the division of Caspian Sea oil rights in 1997.

It is possible to "pre-fund" future benefit payments without creating a mandatory accumulation system. A mandatory accumulation system is simply one way to do it. Reserves could simply be accumulated in the existing solidarity system and those reserves could be invested the Treasury or some other government agency. Alternatively, private asset managers could invest reserves without those accumulations being allocated to individual accounts. A mandatory accumulation system is, however, a good way of putting the assets out of the reach of government officials and of Parliament by giving individuals property rights over the money invested.. This means the reserves are more likely to be invested properly and to be available when they are needed.

But if reserve funds are simply invested in State securities, no real pre-funding has occurred. The United States Social Security system lends reserves to the government by purchasing special state securities and earns a lower income than it could receive if it engaged in wider investments. The Social Security system is simply being used to lend money to the government at low rates. To earn higher rates of return, reserves should to be invested by private asset managers where they can earn a higher rate of return for future beneficiaries than is earned by investing in government securities -- and where investment decisions are not subject to influence by the government or the legislature.

3.1.2 Privatizing Pension Administration and/or Asset Management

The second reason often considered for creating an accumulation pension system is to transfer the primary responsibility for administering the collection of contributions, the investment of proceeds, and the distribution of pension benefits from the government to the private sector. Under the state solidarity system, the government monopolizes all these functions. The growing worldwide volume of privatization of activities that were formerly government monopolies – from telecommunications companies to water suppliers — attests to the fact that many governments are realizing that there are operations the private sector performs better than the government. By creating competition among private companies to provide pension related services, taking advantage of the private sector's profit motive, and utilizing efficient private capital markets to invest system reserves, the overall cost will decrease, and the overall efficiency and fairness of the pension system will increase because this government service is now "privatized". This is no different from deciding to privatize any other industry that was previously controlled by the government.

It is important to note that it is possible to privatize some functions of the private pension system without privatizing everything. For example, in Bolivia, the government retains the responsibility for collecting contributions, distributing benefits, and record keeping. However, the asset management is privatized through a tender process. In Poland, contributions are collected by the government, and then remitted to the private pension funds. However, the asset management and benefit payment functions are performed by the private sector. For private pension funds, Kazakhstan follows the Polish model. However, the government provides all services to people who select the SAF.

Establishing a mandatory accumulation system reduces the government's role in the economy. It allows citizens to choose how, and with whom, they wish to save their money for retirement. Individual citizens – not government bureaucrats – are responsible for taking care of their own retirement savings. The government is responsible only for helping supplement the incomes of people who have not saved enough – because of prolonged unemployment, sickness, or other problems in the labor market. The government is also responsible for regulating the private pension industry to protect participants' rights. Government is no longer managing a huge social insurance program. It is primarily the provider of a much smaller social welfare program. Its role has changed from primary provider to regulator.

Of course, the debate over whether to privatize the pension system becomes purely theoretical if the country lacks the private capital markets, investment opportunities, and institutions to support a private pension. This was, and is, the position of Kazakhstan and of Ukraine today. Responsibility can be transferred to the private sector only if the private sector exists, and if there is good reason to believe it can perform these roles better than could government agencies. Otherwise, when the new and unsupported private pension system inevitably fails, the government will be forced to "re-nationalize" the pension system at great financial expense. The government will be far worse off than it was before reform, because it will have all its old responsibilities back, plus the enormous cost of repaying the losses incurred in the failed privatization. The GOK could not justify the reforms as an attempt to privatize the pension function because Kazakhstan lacked most of the building blocks of a private capital market. . Instead, the GOK chose to privatize, and immediately re-nationalize through the State Accumulation Fund. Consequently, their privatization was merely virtual, not real.

3.1.3 Forcing People to Set Aside Money for their Old Age

All governments provide assistance for poor people. This can create a problem by discouraging people from looking after themselves. If some people save money during their working lives and receive pensions from the incomes from their savings, they will not need – nor receive – any social assistance from the government. Other people, who spend all they earn while they are working, will need social assistance when they are old. By creating a mandatory accumulation system, therefore, the government can force citizens to save for their own retirement. This is a necessary counterbalance to the incentive toward irresponsible behavior that the government social assistance system provides. If the government were simply to reduce the level of pension benefits from the solidarity system without introducing a mandatory accumulation system, many more elderly people would need to be provided with social assistance. The government has simply switched responsibility for financing social protection from the old-age pension system to the social assistance system.

In Western countries, it is possible for government pension programs to provide much lower benefit levels than in Ukraine. This is because elderly citizens have substantial additional assets at retirement, primarily due to equity accumulated in private property and the ability to save safely in banks and other financial institutions, and because the poverty level is a much lower percentage of the average wage than in Ukraine. Consequently, there is a much stronger argument for a <u>mandatory</u> private pension program in Ukraine than in the United States or other Western countries.

3.1.4 Depoliticize Pension Policy

If the pension system is privatized, people will receive old age pensions in an amount directly and transparently linked to what they contributed into the private pension funds during their working lives. Politicians can no longer promise to raise pensions today in exchange for votes – storing up fiscal problems in the future – because they no longer control the pension system. This issue is vividly illustrated by the current Ukrainian Presidential election campaign, where just prior to the elections, back wages and pensions were paid, the minimum pension benefit was increased, and a one billion hrivnya emission was issued by the National Bank of Ukraine.

Of course, none of these reasons necessarily justifies the creation of a mandatory accumulation system. Each goal can be met without creating a mandatory accumulation system. Privatization and depoliticization, for example, can be achieved by simply terminating the state solidarity system. Protecting the state from excessive welfare payments in the future can be achieved by maintaining the current solidarity system. And stabilizing the balance between contributions and expenditures is achieved through pre-funding.

Nevertheless, a mandatory accumulation system is one way of meeting all these goals at the same time. Many countries have found the combination of reasons to be sufficiently compelling to create mandatory accumulation systems.[16] The World Bank, in its 1994 study of pension policy, has recommended that a mandatory accumulation system be one of the three "pillars" (together with a solidarity system to ensure basic pension benefits for the elderly and a voluntary private system) that support a healthy, balanced pension system.[17]

3.1.5 Consequences of the Failure to Understand the Purpose of Creating a Mandatory Accumulation System

In Kazakhstan, the failure to understand why the mandatory accumulation system was being introduced led to serious design errors. The GOK lacked any clear goals and thus lacked any guiding vision to design a system that would meet the goals. As other countries have done, Kazakhstan justified an accumulation system as a step toward increasing "transparency" of the system. People would always know how much money they had accumulated toward their retirement benefit. It was also seen as a way to provide the country with a source of long-term capital to support economic growth.[18] And Kazakh policymakers were encouraged in this view by international donors and pension experts who not only argued strongly in favor of creating an accumulation system but offered financial and technical support to the GOK if it followed this path. To GOK policymakers and international experts, creating a brand new pension system seemed a more attractive alternative to trying to fix the poorly functioning solidarity system. In pursuing the overall objectives of developing capital markets, the GOK failed to give much weight to the important issues of benefit adequacy and protecting the interests of present taxpayers and future pensioners.

In the absence of a clear model of the relationship between a solidarity system and the accumulation system, the GOK felt that they should control the new system in much the same way as they controlled the old system. They were forced into this view because they had, of necessity, been forced to fund the new system by incurring debt. The only place where the fiscally overburdened Government could raise the money to pay for the new system was by selling its bonds to the new system as its major assets.

Although the GOK had intended to relinquish to private financial entities a portion of their responsibility for pensions, it could not continue the reforms unless it could maintain control over the ready market for its own bonds at a price which it could afford. Since the GOK's conceptual framework did not clearly divide what was private from what was public, it was acceptable to force private pension funds to give away huge competitive advantages to the SAF, and then force the SAF to loan money to the government, directly or indirectly, to pay for pension reform.

The most basic decisions, the starting point for all pension discussions should be:

- What parts of the retirement security system are the responsibility of the government, what parts the private sector?
- Should participation in the retirement system be mandatory or voluntary? Should the answer differ for different groups of workers?

[16] Countries that have created mandatory accumulation systems include the well-publicized system in Chile (created in 1981) and recently copied in Mexico, XXX and XXX. Accumulation systems have also been created in XXX XXX XXX
[17] See *Averting the Old Age Crisis*: A World Bank Policy Research Report, Oxford University Press, 1994
[18] It is important to note that international donors contributed to the misunderstanding about the reasons for creating a mandatory accumulation system. USAID's program of technical support to the GOK for pension system reform was delivered through the capital markets reform program, not through the programs dealing with social sector reform.

- What level of income should be provided to workers at retirement by the government (if any)? Should the government's obligation be expressed as a percent of pay, a flat benefit amount, or some other basis? What is the government's role in retirement security?
- How should government-provided pensions be financed? Payroll taxes? General revenues? Other? What is the responsibility of employers and workers for retirement system funding?
- Can the government afford the cost of introducing the new system -- when the unavoidable costs of retaining parts of the old system are included? Can the program survive in good times and in bad? How should the cost be measured? What pattern of costs is desired over time?

Governments must also honestly evaluate, regardless of their philosophical inclinations, whether they are capable of supporting an effective private pension system today. In Kazakhstan's case, as with Ukraine and other countries in the FSU, the answer is no.

3.2 FAILURES BECAUSE OF POOR FISCAL ANALYSIS

The Kazakh pension reform broke the bank. The GOK and many influential advisors from international donors underestimated the costs of reform and overestimated the revenues that would be generated by the expanding oil sector and through the privatization of state enterprises that would be used to cover these costs. Even before the reform began, it was abundantly clear that the solidarity system was already suffering large deficits and that these deficits were likely to continue to grow.[19] Compliance rates in the solidarity system further declined following reform as the gray economy expanded (a phenomenon exacerbated by poorly chosen administrative actions discussed later).

As soon as the new accumulation system was introduced, 40% of solidarity revenues were diverted to fund it as payroll contributions were cut from 25.5% to 15%. The already large deficits grew. General revenues from the state budget were used to pay benefits owed under the old solidarity system. The bad situation worsened in August 1998 when the financial crises in Russian led to the devaluation of the local currency, a slump in exports (Russia purchased nearly three quarters of Kazakh exports), and inflation. Taken together, costs proved far larger than the State Budget could afford. Deficits grew and benefit arrears re-emerged

Following reform, the total cost of pensions to the State budget was approximately $1 billion USD per year, based on exchange rates at the beginning of 1998. This was nearly 5 percent of GDP. To sustain the pension program, the GOK was forced to make sharp reductions in other program budgets, including sharp cuts in both the healthcare and education budgets. The extravagant costs of moving the national capital from Almaty to Astana squeezed state budget revenues still further

Despite clear evidence that the GOK could not afford their pension reform program, government officials refused to change course. Instead, they took further actions to make sure the pension reform could never be reversed. The GOK changed the 15% dedicated payroll tax to part of general tax revenues, moved responsibility for collecting solidarity system contributions and for paying solidarity system benefits from the State Benefit Payment Center to the State budget. The GOK stubbornly clung to its pension reform despite clear evidence it was failing.

Some of the GOK's efforts to resolve the fiscal problems stemming from pension reform further showed their lack of understanding of pension system financing. Earlier this year, the GOK proposed reducing the <u>employee</u> contributions to the mandatory accumulation system as a way of solving the system's financing problems. However, this would not increase revenues to the solidarity system. It would only reduce future benefits to workers from their accumulation accounts. Such a reduction would have almost no fiscal impact.

[19] See financial projections prepared by XXX in ZZZ.

The employee's take-home pay might just go up by the amount not contributed. Ultimate pension benefits might fall, consumption spending might increase, government tax revenues might increase. But it would have little impact on the financing of the government budget deficit and the deficit in the solidarity system. Again, this shows fundamental misunderstanding of the pension reform financing.

Even as the fiscal consequences became apparent, the GOK was encouraged to continue with its plans by foreign donors who were anxious to show successes in Kazakhstan in their programs of financial and technical support. Finally, in October 1999, President Nazerbaev decided to replace the officials responsible for these poor decisions, and it appears the entire pension program will now be re-evaluated.

3.3 FAILURES CAUSED BY KAZAKHSTAN'S UNDEVELOPED CAPITAL MARKETS

Kazakhstan lacks private capital markets. In 1998, there was only a single A rated corporate security. Private commercial banks had only recently been created – although Kazakhstan has moved further toward creating modern financial institutions than has Ukraine. Although there are some joint ventures with western financial institutions, many banks have still not developed the sophisticated management experience, information systems, reporting and audit procedures, and regulatory superstructure that characterize western capital markets. Because of the speed with which pension reform was implemented, these undeveloped institutions would be suddenly called upon to manage enormous flows of capital diverted into private pension funds through the new accumulation system. The GOK's response was to rush into existence a state financial institution – the State Accumulation Fund (SAF) – to supplement the weak private institutions. The government's reason was that many citizens would not trust the new and untested private pension funds but would trust a government fund. Unfortunately, as a state institution, the SAF was subject to the very political influences on its investment activities that the creation of a privately managed, mandatory, accumulation system should have been created to eliminate.

The weakness of private capital markets was further undermined by two related decisions that were made during the implementation period:

- The cancellation of the blue chip privatization program four months after the pension law was passed, effectively eliminating most private investment opportunities within Kazakhstan for the new, and rapidly growing, pension funds.
- A prohibition on overseas investments, which shut the new pension funds out from safe investment opportunities as well as isolating these emerging private institutions from the salutary influence of foreign capital markets.

3.3.1 State Accumulation Fund (SAF)

The creation of the SAF transformed the mandatory accumulation system from a private pension system into a predominantly state-run system. The government inevitably began managing the SAF investments for its own benefit rather than for the benefit of contributors. The GOK gave the SAF significant advantages over the private funds. They made it the default fund under the law, subsidized it through the State budget, exempted it from the requirement to hire an outside asset manager, and allowed it to charge the same fees as private funds even though its expenses were much lower. Also, at the time the pension reform started, there were no licensed private funds, so all money went to the SAF. Anyone not wishing to invest through the SAF would have to make a conscious effort to transfer out of it and find an alternative program. Although private funds now exist, about 80% of all assets are still in the SAF now.

The National Bank of Kazakhstan was given the task of acting both as asset manager and custodian (dual roles denied to private sector entities) which strengthened the apparent "safety" of the SAF in the eyes of the public and made competition from private forms doubly difficult. The National Bank, as a subsidized state entity, was required to charge the SAF management fees well below market rates further undermining the possibility for proper competition with private firms. Similarly, the SBPC was required to provide marketing and record keeping services at below market fees.

The National Bank's investment policy was tailored to meet the needs of the GOK and was not required to comply with the rules under which private entities operated. It invested only in government bonds and in deposits at State-owned banks. Of course, after the Kazakh blue-chip privatization program was cancelled, the SAF and private funds were faced with the same investment options

These actions alone changed the whole nature of the new accumulation system. Almost all contributions flowed to the SAF (90% in the first 12 months of operations) and its assets were managed by the government. Private pension funds were starved for contributions and never gained sufficient size to enjoy the economies of scale in their operations that would allow them to survive financially. By the middle of 1999, there were XX private funds in operation that controlled only XX percent of the total assets accumulated through the new system. All the rest were controlled by the SAF.

The SAF provided the government with the only way to finance its new pension system. With the mounting deficits, noted above, the government needed to borrow more and more money just to keep paying the pension benefits it was obligated to pay under the old solidarity system. It could borrow at low cost if it made the new SAF its primary lender. Therefore, the Cabinet issued a decree requiring all assets of the SAF to be invested only in State securities. This could easily be implemented because the NBK, acting as the Fund's investment manager, simply purchased State securities at interest rates well below what the government would have been forced to pay had it sold the securities on the open market. At that time, Kazakh private pension funds and foreign investors were unwilling to buy Kazakh State securities.

In April 1999, all available SAF assets were used to buy a special issue of government bonds at 6.45% interest. At that time, when inflation had reached 10%, the budget deficit had reached 8% of GDP, and the tenge was about to be devalued by 30%. The NBK, as investment manager, violated every international standard of fiduciary conduct by continually purchasing Kazakh securities that no one else wanted at interest rates which did not reflect the triple risks of default, devaluation, and inflation. The NBK acted in the best interests of the government, not in the best interests of participants. Not surprisingly, more and more participants in the accumulation system began exercising the difficult option of choosing private pension funds. The percent of assets invested in the SAF declined from 100% on January 1, 1998, to about 70% today. The SAF, however, continues to dominate the market. The GOK cannot afford to consider dismantling it.

3.3.2 Cancellation of Blue Chip Privatization

When the pension reform law was enacted, the government planned to privatize many large, state-owned Kazakh enterprises through stock market issues. Privatization was to be, for the most part, open to foreign investors – a fact that would have pressured privatized companies to restructure and compete. This would enhance the value of the new shares issued as a result of privatization and introduce much-needed international capital standards into the domestic securities market. The new private pension funds were anticipated to be one of the major buyers of these new shares. Pension reform, privatization, and the development of the local capital markets were seen as linked activities. Private pension funds are legally permitted to purchase these shares, while the SAF is not, which would give them a competitive advantage. This would encourage contributors to switch to the best of the new private funds.

The pension law was signed in July 1997. In November 1997, the blue chip privatization program was cancelled abruptly – precipitating a change in the government. The cancellation s was caused by the same factors that have slowed privatization in other members of the former Soviet Union. The managers of state-owned enterprises felt threatened by privatization, fearing – many with good reason, -- that shareholders would require a change of management as part of the business restructuring.[20] In Kazakhstan, it also reflected a change of philosophy regarding privatization of the oil industry, intensive debates about whether the government was receiving a fair price for prior privatization (particularly in the oil industry), and the price which at oil-related companies could be sold in late 1997 -- a time of low oil prices. Politicians, for their part, did not want to their control over industry to pass into private hands for it would have led to the shrinking of the bureaucratic apparatus that controlled the activities of state-run enterprises. The termination of the privatization program effectively destroyed any advantage private pension funds may have been able to gain over the SAF. Available and permissible investments were now the same for everyone, but all legal and financial advantages remain with the SAF.

3.3.3 Prohibition of overseas investments

The Kazakh pension law does not allow foreign investments today – although modest levels of foreign investments are envisaged in the future. It is permitted, however, to purchase bonds issued by international organizations such as the World Bank, and it is possible for private pension funds to purchase Kazakh Euro-bonds issued by the government and some Kazakh corporations. The Euro-bond purchases have the advantage of being denominated in foreign currency and have outside custodians.

When a country like Kazakhstan, with underdeveloped private capital markets, prohibits foreign investments, asset managers cannot meet their fiduciary obligations to participants. International standards for asset managers require them to invest <u>solely</u> in the best interests of their contributors. Their job is to earn the highest possible rate of return for their client without taking unreasonable risks. Pension money should <u>never</u> be invested speculatively. It should be invested only in relatively safe and liquid investments, with minimal probability of default or large changes in value. Investments should be diversified widely among different kinds of securities, and in different industries, regions, and currencies. These are the basic international investment standards designed to protect plan participants.

Kazakhstan offers few safe investments within its borders. If all investments are denominated in tenge, investors face large risks of losses through high inflation and currency devaluation. Placing all pension assets in State securities exposes participants to the risk of losses should the government default on its debt or rescheduling interest and principal payments. Neither should all investments be concentrated in bank deposits, because the risk of losses due to bank failure is too high. Kazakhstan also lacks enough "A-rated" securities. The only reasonable investment decision is to allow pension funds to invest in an international portfolio of securities – especially during the early years until domestic capital markets have developed sufficiently to supply safe domestic investments. Unfortunately, foreign investments are often opposed for political reasons. Politicians believe that allowing funds to "leave the country" means the loss of capital to support domestic economic development. They fail to understand that foreign investments today create a stream of "hard currency" earnings in the future and that pension funds must be managed to provide the highest possible yield for participants – creating a wealthier group of retirees in the future.

3.4 FAILURES BECAUSE OF POOR DECISIONS DURING DESIGN AND IMPLEMENTATION

In addition to its large fiscal and financial problems, the government of Kazakhstan made the problems with its new pension system worse by failing to properly design, build, test, and implement the its new administrative systems. The clearest mistakes were:

- Failure to create a properly functioning State Benefit Payment Center.
- Failure to personify the solidarity system.

[20] See XXXXX

- Changing twice the organizational responsibilities for collecting contributions to the solidarity system

3.4.1 Failures of the State Benefit Payment Center

The State Benefit Payment Center (SBPC) was created as part of pension reform, and given several critical functions, none of which if fulfilled successfully because it was given insufficient time to develop the necessary skills and systems and because the GOK vastly underestimated the difficulties involved in setting up these activities. Only after committing itself to creating the accumulation system did the government realize that it lacked a unique identification number that would remain unchanged during an individual's lifetime. Passport numbers changed each time the passport was renewed. Tax identification numbers changed if a physical or legal entity moved to a new raion or oblast. Pension fund account numbers created by the new funds would also change if people changed the fund nominated to receive their contributions. With no unique ID, there was no safe way of maintaining lifetime records of individual's contributions into their mandatory pension accounts. The government needed to create a new numbering system that could be used to identify the individual pension accounts. Creating a unique identification number is a monumental task in a country that lacks national, computerized record keeping systems. The result of trying to create the new numbering system too quickly has been chaos. Today, about 3 million SICs have been issued, but many of these are duplicate numbers for the same individuals. In reality, only about 1.5 million citizens have received SICs in a country with a registered workforce of about 3.5 million, total employment of 7 million, and nearly 2 million retirees.

The SBPC also had problems with properly collecting payroll contributions and allocating them between the two pension systems. Many errors were never corrected because paper "back-up" records were not kept. In addition, the software for processing contributions proved inadequate. In the first few months, computers rejected almost 90% of all data received because of errors in data entry. All contributions that arrived without attached personified data files were automatically allocated to the solidarity system contributions, even if the account code clearly indicated they were accumulation system contributions. This resulted in loss of contributions to the accumulation system and of investment income for participants. Many of these errors will probably never be rectified.[21]

Experience shows it takes three or four years to properly build and test the systems even if technical support is provided by experienced international experts. The comparable systems in western countries have evolved over more than half a century. It is unrealistic to expect newly independent states to catch up in a year or two. When administrative systems fail, it fails visibly – affecting the financial health o millions of people, and destroying the credibility of the new pension system, regardless of how well it was designed.

Another SBPC problem is that it was unable to fulfill its logical roles as a clearinghouse for pension contributions and as an audit center. In 1998, the SBPC collected contributions from all employers for both systems. This should have allowed it to audit data for obvious inconsistencies and to reconcile data against information submitted to other government agencies, such as the State Tax Administration. The SBPC was never used for these tasks. Instead, lacking proper, computerized record keeping and reporting systems, it only slowed the flow of funds from employers to pension funds. The SBPC intercepts contributions to the mandatory accumulation system, holds them for a period of time, and then sends them to the custodian bank for the appropriate pension fund.[22] While it holds the money, the SBPC undertakes no auditing or information clearing function. Consequently, there is no real reason for its continued existence. Pension funds

---

[21] Poland has also experienced problems in implementing its pension reform program because it allocated too little time and resources to create the necessary management information systems.

[22] During the delay, the SBPC (or, perhaps, the National Bank), may actually earn interest on the retained money, although the extent of these earnings is unclear.

could easily maintain personified records, and money could easily be sent directly from employers to pension funds, with duplicate information forwarded to the government regulatory agencies.

Some of SBPC's problems arise from its reliance on a single software company – Crystal Lane – to do all its programming. The SBPC does not have the source code and does not understand the basic structure and algorithms of the underlying software. Consequently, all software questions must be answered by the software developer who must make all changes. The SBPC does not have its own internal data security procedures. Consequently, Crystal Lane has access to data and numbers. This creates a dangerous security risk.

3.4.2 Failure to Personify the Solidarity System

When pension reform was introduced, the GOK decided to require personified reporting and to maintain personified data only for the mandatory accumulation system, not for the solidarity system because the latter was being eliminated, and did not need personified records. This was a serious mistake. Although working people no longer accumulated service credits under the old solidarity system after January 1, 1998, (the date of pension reform), wages earned after this date are used to calculate benefits at retirement. Personification of the solidarity system would have ensured that the wages used in calculating average monthly earnings at retirement were accurate. Also, by personifying the solidarity system, employers would have been forced to report wages of each employee to the State Benefit Payment Center (SBPC) for both pension systems at the same time. This would have made it easier for the government to verify that employers were contributing to both systems for all employees and that the amounts contributed were correct in relation to each other. This would have improved compliance in the solidarity system. Instead, it has deteriorated significantly.

3.4.3 Changing Responsibility for collection of solidarity system contributions

In three years, Kazakhstan has used three different government organizations to collect solidarity system contributions. In 1997, prior to pension reform, contributions were collected by the State Pension Fund of Kazakhstan. As part of reform, the State Pension Fund was abolished at the beginning of 1998, and the State Benefit Payment Center (SBPC) was created and made responsible for collecting personified records and contributions to the mandatory accumulation system and to collect non-personified contributions to the solidarity system. In 1999, however, the government took a further step to ensure the final abolition of the solidarity system. It redefined payments to the solidarity system contribution as another general tax and moved responsibility for collecting this "tax" to the State Tax Administration. As a result, there is no longer a dedicated payroll contribution to pay solidarity system benefit obligations.

The net result of these changes has been confusion and two sharp declines in the rate of compliance. When the Pension Fund was abolished and collection responsibility was moved to the SBPC, employers were not properly informed of new procedures, nor taught how to submit data in to the new entity. Consequently, compliance was low in the first few months following reform and has never returned to 1997 levels. Compliance for the mandatory accumulation system remained higher than for the solidarity system because the mandatory system was personified and the solidarity system was not. Also, solidarity system contributions were not viewed as buying very high future pension benefits, so there was a natural reluctance to pay them.

When collection responsibility was moved from the SBPC to the State Tax Administration, the compliance rate fell again. There was neither personification nor an SBPC to compare contributions for the two systems. Mandatory accumulation system contributions were now collected by one entity and solidarity contributions by another. As a result, compliance is unlikely to improve.

3.4.4 Regulatory Issues

The design and implementation of the regulatory system – vital if the interests of the pension fund participants are to be protected – have suffered from poorly thought out and badly executed decisions. The problem of rapid change in the regulatory system is that Kazakhstan, like other FSU members, does not have a long history of regulating financial institutions. There have been well-documented problems with bank failures, pyramid schemes, and the coupon privatization program. For a long time, private pension funds operated in the complete absence of law and regulations. While Kazakhstan had some success in managing state enterprises, it had no experience regulating non-state financial institutions prior to pension reform. Such regulatory systems can be built quickly and expected to run well. There are too few experienced professionals to run the regulatory organization, and state regulators are paid too little which leaves them vulnerable to corruption.

The National Pension Agency, for example, is a new agency created as part of pension reform, and responsible for regulating the activities of pension funds. The NPA was created within a few months as part of the Ministry of Labor, not as an independent organization. This agency was built from scratch in just a few months, and has suffered from the speed and lack of independence. There have been documented cases of political influence on its licensing and other decisions. In several cases, it has been reported that the regulator was told to license certain companies that may not have met the requirements for a license. In one case, a fund sponsored by a public organization was licensed – I direct contradiction of the pension law and an agreement between the GOK and the US Government. This was eventually reversed. But without reform in NPA's organizational structure, it is unlikely that the problem can be eliminated.

Key provisions of the law were violated with no response by the regulators. The pension law states that participants may choose among all licensed pension funds. Employers and others are not permitted to influence their decision. In many cases, it has been reported, employers were making transfer decisions on behalf of all their employees. In most cases, transfers were made to funds sponsored by organizations with whom employers had business relationships. This is a clear violation of the law, and a conflict of interest. The employer's decision was not based on the best interests of participants, but to help friends (and, perhaps, himself).

Anti-affiliation rules have also been violated. The pension law states that the custodian must be completely independent from the pension fund and asset management companies. This makes good sense. The custodian keeps physical possession of the contributors' assets in order to protect them. This is one of the key safeguards in the pension system. The custodian is supposed to watch the activities of pension funds and asset managers, and report violations to the regulators. If the custodian and the pension fund or asset management company are related companies, this protection is lost. There is a strong possibility of collusion and theft. In several cases, it is reported, the custodian was not independent.

The regulatory organizations were initially unaware of these problems. When informed, they argued it was not their responsibility unless someone brought proof of the charges to the agency. Today, regulators have acknowledged problems and have begun to investigate them. However, given the lack of experience of the staff, their low pay, and the lack of training, there are probably many other violations as yet undiscovered. In a mandatory system, the total assets increase very rapidly. In the absence of good regulation, large sums of money can be lost quickly. It is very risky to start a private pension system with such large amounts of money and an untested system of enforcement.

4. LESSONS FOR UKRAINE

4.1 SUMMARY OF THE REASONS FOR THE FAILURE OF KAZAKHSTAN'S PENSION REFORM PROGRAM

4.1.1 Failures in the Concept of Pension Reform

The Government failed to define clearly what it intended to achieve through reform of the state pension system. The Government did not understand the basic purposes of a state-mandated pension system nor how this state system should be linked to a private pension system. Neither did it understand the relative roles that should be played by a pay-as-you-go (solidarity) pension system and a pension system that is fully funded (an accumulation system). From the viewpoint of the Government, the primary goal of pension reform was to finance the budget deficit at low cost and to help develop the capital markets to support long-term economic development. By emphasizing these goals, the Government failed to pay attention to the fact that the primary goal of pension systems should be to provide adequate retirement income to pensioners, and maximize rates of return in the accumulation system.

Lesson: Clearly define the goals and objectives of the new system, place the interests of participants first, and set benchmarks

4.1.2 Failures Because of Poor Fiscal Analysis

The Government has suffered huge budget deficits in 1999 that are the direct result of its failure to properly analyze the existing deficit in the solidarity system and the additional deficit that would result from the creation of the new mandatory accumulation system that was the centerpiece of Kazakhstan's pension reform.

Budget revenues have fallen as economic activity flees into the gray economy due to poor government economic policies. The East Asian and Russian financial crises made the already bad situation worse by reducing Kazakh economic growth, weakening the currency, and causing foreign investors to leave the country.

Lessons: Get the numbers right, don't borrow to create an accumulation system, identify sources of financing, and set realistic benchmarks

4.1.3 Failures Caused By Kazakhstan's Undeveloped Capital Markets

Asset managers were unable to find sufficient safe, liquid, well diversified securities to invest the mandatory contributions because of Kazakhstan's undeveloped capital markets and the legal prohibition against investing pension funds in foreign assets in the early years of the program and because of the cancellation of the blue chip privatization program. The National Bank of Kazakhstan – which manages most assets in the system – was further limited in its investment portfolio. The result is that all funds have created non-diversified, illiquid portfolio of risky assets. Overall, investments have been managed to help the government finance its debt at low interests not to allow participants to earn a high yield.

Lessons: Don't create a mandatory accumulation system until capital markets are sufficiently evolved and allow international investing

4.1.4 Failures Because of Poor Decisions During Design and Implementation

The last minute creation of the State Accumulation Fund as one of the entities that could manage the funds of the new mandatory accumulation system changed the new pension system from one based on private asset management to one dominated by State asset management, resulting in a pension system based on two State run pension programs – the old solidarity system and most of the new accumulation system , for which the state collects contributions and manages the assets.

Solidarity system compliance rates fell sharply due to failure to personify the reporting and record-keeping of the solidarity system, as well as the decision to change, during the pension reform process, the agency responsible for collecting solidarity system contributions.

Inadequate time was spent building the administrative systems to support the reformed pension system, resulting in issuing many erroneous individual identification numbers, inability to track individual account balances, and misallocation of contributions between the solidarity and accumulation systems.

Failure to enforce the pension reform law, through inadequately planned implementation of the new regulatory agency overseeing pension funds, the National Pension Agency. This resulted, for example, in violation of the anti-affiliation rules between custodians and asset managers or pension funds and of participant's rights to freely transfer money among pension funds.

The administrative functions of the State Benefit Payment Center were implemented poorly, creating an agency unable to do anything other than slow the flow of money from contributors to pension funds with no monitoring or oversight capacity.

Lessons: Don't rush the process, test procedures first, and invest in proper management information systems.

4.2 PUT THE PARTICIPANT FIRST

Any pension system, however structured, exists primarily for the benefit of retirees. Mandatory pension programs prevent poverty among the elderly. If the system does not do this, it has failed. With respect to any accumulation system, this means all investment decisions must be made with the sole objective of maximizing returns to participants while minimizing risk. If investment decisions are made on any other basis, the system will fail. Every single investment decision must be made with the goal of choosing the single best investment for the participant. All other goals and objectives must be secondary to pension benefit adequacy, and maximizing investment return to participants. Once this objective has been met, if the system can also aid – as a secondary objective – in achieving other economic objectives, this is fine.

Putting the participant first also means establishing a system which is well regulated, in a legal environment in which participant's rights are thoroughly protected, and where profitable, low risk investments are available. This cannot occur safely in a country with a declining economy, unstable currency, high inflation, and an unstable commercial banking system. It cannot occur in a country with poor corporate governance, inadequate protection of minority shareholder rights, virtually no market capitalization, and lack of proper accounting standards.

4.3 GET THE NUMBERS RIGHT

Most countries are so anxious to introduce some type of mandatory accumulation system quickly, that they don't focus on getting the numbers right. They manipulate the numbers to give the answer they want, fail to be very specific about how each year's transition cost will be financed, and are unrealistic about budget revenues, likely privatization proceeds, and the total cost of pensions to the budget.

Most countries also fail to clearly articulate why they are introducing the mandatory accumulation system. Is it in order to pre-fund pensions and level costs over time? Is it because they believe the pension system should be privatized? These different reasons for establishing a mandatory accumulation system lead to very different conclusions about pension financing. For example, deficit financing of the introduction of the mandatory accumulation system makes no sense if the purpose of establishing the system is to pre-fund future pensions.

We believe it is a mistake for any FSU country to use deficit financing or dedicated privatization proceeds to pay for the cost of transition. The only reasonable method is to save first and spend second. Savings must be generated – either within the existing pension system or elsewhere in the budget – and then be used to finance the mandatory accumulation system. This will usually mean a gradual increase in the percent of pay going to the accumulation system over time.

4.4 ALLOW ADEQUATE TIME FOR DESIGN AND IMPLEMENTATION

Most countries have rushed the implementation phase of the pension reform. Whether the design is done very quickly, as in Kazakhstan, or over many years of debate, as in Poland, implementation is rushed once legislation is completed. In most countries, this has resulted in severe problems with computer systems, the regulatory structure, or both.

Personification systems in Hungary, Poland and Kazakhstan are suffering from severe problems. These are complex systems, which must gather individualized data on every participant, and track these properly throughout the person's working career and retirement. In most countries in Eastern Europe and the FSU, the pension system are very complex. There are so many special rules for different classifications of workers, which create the need to track vast amounts of specialized information. There is little expertise in this region of the world with large social insurance database and individual records. Invariably, local firms do not have the required experience, the government rushes the implementation process, and the government often fails to give the administrative organization reasonable budgets for implementation of the changes. Experience has shown that poor administrative systems can ruin even a well designed pension reform.

The same can be said for a regulatory organization. Rigorous enforcement of the law and protection of participant rights is needed. One of the reasons for the success of the Chilean system is the high degree of professionalism and the very detailed oversight of the industry provided by the regulator. This is a difficult task even in Western countries with a long history of regulating private financial institutions. This is a monumental challenge for the countries of the FSU. They have almost no experience regulating non-state financial institutions and a history of scandals – such as trust fund pyramids and the coupon privatization funds – in their few efforts at dealing with such organizations. There is also a major problem finding qualified professionals – often due to an inability to provide adequate pay – and assuring the independence of the regulator. Establishing and staffing a new organization, creating proper software systems, training personnel, writing model contracts, by-laws and other documents, issuing initial regulations, and establishing standardized manuals and procedures will take vastly more time than the government thinks. If these things are rushed, the result will be disaster.

4.5 EVERYTHING IS INTERRELATED

Pension reform is an integral part of overall economic reform. The design of the pension reform program will have an impact on banking, capital markets, accounting, privatization, GDP growth rates, and many other aspects of the economy. In Ukraine, total spending on pensions is about 13% of reported GDP, and about 28% of the total population is pensioners. Each worker in the formal or informal economy in Ukraine is supporting one non-worker – pensioner or child. Therefore, any change in the pension program is likely to have a ripple effect throughout the economy.

Consequently, any sudden changes in the design after implementation are likely to have a drastic impact on the operation of the system. Kazakhstan provides a perfect example of this. Pension reform was intended to be accompanied by privatization and the development of the stock market. The between 10 and 20 very large firms to be privatized through the stock market would have been “A” listed stocks on the Kazakh stock exchange. All of them had been following Western accounting standards for several years, met proper disclosure requirements, etc. They would have given private pension funds good investment options with potentially high returns – and a distinct advantage over the State Accumulation Fund. When the blue-chip privatization was cancelled, the viability of pension reform collapsed.

The government and Parliament must understand that pension reform is a delicately balanced, complex structure – threatened by any large changes during implementation. Pension reform must be part of an overall economic reform package.[23] This is one of the reasons the Chilean reform was successful.[24] It was part of a well-coordinated economic reform program that also included banking and capital market reforms. Pinochet accepted the package of reforms as a whole, and saved the money to pay for it over the eight years preceding introduction of the mandatory accumulation system. This is the only way the pension reform can be successful.

[23] In December 1996, the Government of Ukraine prepared a comprehensive economic reform package that included pension reform together with the restructuring of the tax system, accelerated privatization, and regulatory reform. The Supreme Rada, however, broke the reform package into parts and rejected all but those elements related to the reform of the VAT and the corporate income tax. The pension reform proposals were abandoned and, in their place, the GOU appointed a Pension Reform Task Force intended to design and draft a new package of pension reform laws. The proposals under discussion by the task force were moving toward a program of reform that was quite close to that followed by Kazakhstan. The process broke down, however, when the GOU rejected the demands of the World Bank that it begin immediately to create a mandatory accumulation system and also begin immediately to raise the pension age.

[24] An analysis of the Chilean model of pension reform will be discussed in another policy report prepared by PADCO.